EXECUTIVE STOCK OPTIONS

by

SARAH JANE SENNER

B. B. A., Washburn University, 1964

A MASTER'S REPORT

submitted in partial fulfillment of the

requirements for the degree

MASTER OF SCIENCE

College of Commerce

KANSAS STATE UNIVERSITY
Manhattan, Kansas

1965

Approved by:

Major Professor

TABLE OF CONTENTS

INTRODUCTION

Management talent has been termed "a scarce and very precious national resource."[1] Competition among firms for the available executive talent has been reflected in executive compensation plans. Because of graduated income tax brackets, the executive retains a smaller part of each additional increase in cash compensation. Therefore, firms have sought supplementary means of compensating executives.

Deferred compensation plans present a partial solution in some cases. Compensation earned in the present is not paid to the executive until he reaches retirement when his total compensation and applicable tax bracket will decrease. For the older executive nearing retirement, such a plan may be ideal. The deferral plans hold certain disadvantages for younger executives. When income is deferred, the executive has lost the use of his capital during the deferral period. To the younger executive who is raising a family and seeking to become established, current cash compensation may appear more satisfactory than cash at retirement. The chief disadvantage for the business firm in deferral plans is the reduced incentive inherent in the long separation between performance and reward.

Stock option plans have become popular because profits earned from sale of stock acquired with options are taxable as capital gains rather

---

[1]Henry Ford II, "Stock Options are in the Public Interest," <u>Harvard Business Review</u>, July-August 1961, 39:47.

than as ordinary income, if certain requirements are met. The period of time between performance and reward is much shorter with the stock option than is true with deferred compensation plans.

The purpose of this report is to explore the following controversial topics concerning executive stock options: the nature of stock options; methods available to executives for financing stock options; the cost to the grantor corporation and to its stockholders; and the accounting for stock options on the books of the corporation. Recognizing that stock options are used primarily because of their tax advantages for optionees, this paper will emphasize the effects of the tax laws on the above topics.

Subsequent discussion focuses on optionees in the "executive" ranks of American corporations.

For convenience, a 25 per cent capital gains rate is used throughout this report; and the illustrative corporate income tax rate is 48 per cent. All examples will illustrate the "qualified stock option."

TAXATION OF STOCK OPTIONS

Provisions of the Revenue Act of 1950

Prior to 1950 profits realized on the sale of stock acquired with stock options were taxable as ordinary income. The Revenue Act of 1950 provided for the treatment of such profits as capital gains, if certain requirements were met.

If an employee stock option met the requirements of a "restricted stock option", no tax was imposed upon the employee until he disposed

of the stock. If the employee held the stock for the required amount of time, any gain on disposition would be taxed entirely as a long-term capital gain, or as part compensation and part capital gain depending upon the difference between the option price and market value of the stock on the date of grant.

To qualify as a restricted stock option certain conditions had to be met.

> Employment--The option must be granted in connection with the taxpayer's employment.
>
> Price--The option price when the option is granted must be at least 85% of the fair market value of the stock . . .
>
> Stock ownership--The employee cannot own more than 10% of the voting stock of the employer, its parent, or subsidiary, at the time the option is granted. This restriction does not apply if the option price is 110% or more of the value of the stock when the option is granted and the option must be exercised within 5 years.
>
> Stock owned by a wife, father, mother, brother or sister of the employee is counted in determining the 10% limit . . .
>
> Exercise of option--The option must be exercised within 10 years from the date it is granted. It must be exercised (a) while the employee is still employed by the grantor of the option . . ., or (b) within 3 months after the employment ends . . .
>
> Transfers--The option cannot be transferred by the employee except at death. Stock the employee acquires when he exercises the option must be held for at least 6 months after it is acquired and at least 2 years after he got the option.[2]

Premature disposition of the stock would result in loss of the right to capital gains treatment.

---

[2]Prentice-Hall 1964 Federal Tax Course, p. 1313.

The employer would be entitled to a deduction equal to the amount recognized as ordinary income on the employee's tax return. If the employee qualifies for capital gains treatment, the employer receives no tax deduction for any part of the stock option.

The Revenue Act of 1950 provided that if the option price was between 85 per cent and 95 per cent of fair market value on the grant date . . .

> The employee has taxable compensation equal to the amount by which the option price is exceeded by the lessor of (1) the fair market value of the stock at the time the option was granted, or (2) the fair market value of the stock at the time of disposition.[3]

The Revenue Act of 1950 made the following provisions for death of the optionee. If the optionee's death occurred after exercise of the option, (1) no income was reported for the optionee if the option price was at least 95 per cent of fair market value; (2) with an 85 per cent to 95 per cent stock option, income was recognized to the extent of the lessor of (a) the difference between the stock value and option price on grant date, or (b) the difference between option price and stock value on date of death. In either case, the basis of the stock to the estate was fair market value at the date of death of the decedent. If death occurred before exercise of the option and after December 31, 1956 . . .

> . . . any appreciation in value of the stock between the time the option was granted and the death of the employee . . . will not result in taxable gain when the stock is sold by the estate or beneficiary . . .[4]

---

[3]*Ibid*., p. 1314.

[4]*Loc. cit*.

If the optionee died prior to December 31, 1956, the estate or heir was granted the same benefits the optionee would have received had he lived.

Employee stock options not meeting the requirements for restricted stock options were treated as unrestricted stock options. When the option was exercised, the optionee recognized ordinary income on the difference between the option price and the market value on the grant date if the stock had a readily ascertainable market value on the grant date. If the stock had no readily measurable market value on the grant date, ordinary income was recognized on the difference between the option price and the exercise price. The basis of the stock then became the option price plus the amount of realized income. Subsequent sale at a price above the new basis resulted in a long-term capital gain if the six-month holding requirement was met.

Provisions of the Revenue Act of 1964

A considerable amount of dissatisfaction over the favorable tax treatment allowed on restricted stock options was expressed during the Kennedy administration. Secretary of the Treasury Douglas Dillon made the following statement in a Senate Finance Committee hearing: "We basically think that stock that is obtained under options should be taxed as ordinary income when it is obtained."[5]

Senator Albert M. Gore led a Congressional fight to eliminate the tax advantages of stock options. In 1961, he introduced a bill before

---

[5] Hearings Before the Senate Committee on Finance, Part I, 87th Cong., 1st Sess., (1962), p. 459.

the first session of the 87th Congress which provided for taxation of profits on sale of stock acquired with stock options at ordinary income tax rates.

After considerable debate and many committee hearings, Congress voted to amend the law on stock options in the Revenue Act of 1964. Optionees can still qualify for capital gains treatment on profits realized from stock options, but qualification has been made more difficult.

Generally, only those restricted stock options granted prior to 1964, or provided for by a written binding contract dated prior to 1964, will continue to qualify for capital gains treatment. For those restricted stock options that still qualify, the provisions of the Revenue Act of 1950 continue to apply.

Beginning January 1, 1964, option plans must meet the requirements of a "qualified stock option" or an "employee purchase plan" if the profits realized from these options are to qualify as long-term capital gains. Congress found that " . . . quite different features are required for key employee stock options and the discount purchase plans made available to employees generally."[6]

The new law specified the following requirements for "key employee stock options or 'qualified stock options'"[7]

---

[6]Senate Miscellaneous Reports on Public Bills, 88th Cong., 2nd Sess., 12616-1:89.

[7]*Loc. cit.*

<u>Plan</u>--The option must be granted under a plan approved by the stockholders within 12 months before or after the plan is adopted. The plan must state the total shares to be optioned and the employees or classes of employees entitled to receive options.

<u>Options</u>--The option must be granted within 10 years from the earlier of the date the plan is adopted or approved by the stockholders. It must provide: (1) that it must be exercised within 5 years after it is granted; (2) that only an employee can exercise while he lives . . .; (3) that it cannot be exercised while an employee has a prior outstanding qualified stock option or restricted stock option.

An option generally is outstanding until it is exercised in full or expires . . .

<u>Price</u>--The option price must be at least equal to the fair market value of the stock at the time it is granted . . .

<u>Stock ownership</u>--At the time the option is granted, the employee cannot own more than 5% of the stock (in voting power or value) of the employer or its parent or subsidiary corporations. Shares that he holds options for are counted in the 5%. If an option puts the holdings over the 5% limit, it can qualify in part up to the limit . . . Shares owned by related persons are also counted for the 5% limit.

The 5% stock ownership limit is increased to 10% if the equity capital of the corporation or corporations is $1,000,000 or less when the option is granted. If the equity capital is between $1,000,000 and $2,000,000, the 5% limit is increased in the proportion that the excess bears to $1,000,000 . . .[8]

To illustrate the limit on corporations with equity capital between $1,000,000 and $2,000,000, if the equity capital is $1,500,000, options can be granted to employees owning 7 1/2 per cent or less of the stock (5% plus 5% x 500,000/100,000,000).

To qualify for capital gains treatment, the optionee must have been continuously employed by the employer from the grant date to three months

[8] <u>1954 Code</u>, Subtitle A, Chapter 10, Part 2, Sec. 422, p. 4140.

before exercise of the option. The required holding period for capital gains treatment is three years from date of exercise.

A Senate Finance Committee Report explained the reasoning underlying the changes made in the Internal Revenue Code by the 1964 amendment. The three year holding period is designed to assure that key employees " . . . are acquiring a 'stake in the business' and not merely turning the stock over as fast as the options can be exercised." The maximum period of time over which an option may be outstanding has been reduced because

> . . . where the option may be exercised over a very long period of time, such as 10 years, its grant appears more closely associated with compensation and less directed toward the individual efforts to improve his company's business and thereby raise the price level of the stock.
>
> Stockholders approval is required to give assurance that benefits granted management . . . are in accordance with the desires of the stockholders.
>
> It was thought unnecessary to provide employees who are substantial stockholders with any incentive to improve the business since they already have a substantial stake in its successful operation.[9]

The Revenue Act of 1964 separated employee stock purchase plans from qualified stock options because it held that options made available to nearly all employees were designed primarily as a means of raising capital rather than as incentive.

> . . . except for addition of the nondiscrimination requirement (and the requiring of stockholder approval) the tax treatment of employee stock purchase plans continues to be substantially similar to the tax treatment of restricted stock options.[10]

---

[9] Senate Miscellaneous Reports on Public Bills, op. cit., p. 89.

[10] Ibid., p. 94.

NATURE OF
EXECUTIVE STOCK OPTIONS--COMPENSATION OR INCENTIVE

Does an executive stock option represent incentive or compensation? An example will clarify the question.

On January 1, 1964, an executive in the 60 per cent ordinary income tax bracket is granted a qualified stock option (under provisions of the Revenue Act of 1964) to purchase 3,000 shares of his employer's stock at $100, the fair market value on the date the option is granted. The executive exercises his option two years later when the stock is selling for $120. Three years after the option is exercised the executive sells the 3,000 shares for $150 per share. According to the Revenue Act of 1964, the $150,000 gain would be taxed as a long-term capital gain, assuming all other requirements for the qualified stock option are met. The executive would retain $112,500 after paying the long-term capital gains tax. If, however, the $150,000 gain were taxed at ordinary income tax rates, the executive's net gain after taxes would be $60,000.

Whether the gain realized through use of stock options should be taxed as ordinary income or at the capital gains rate was argued in the tax courts for many years prior to 1950. The tax question could be restated as: Does the gain accruing to executives who exercise stock options represent a compensation payment or an incentive payment? If the option were granted as an incentive, i. e., to give the employee a proprietary interest in the firm, the gain should only be taxable as a capital gain. If, however, the option were granted as compensation, the optionee should be subject to ordinary income tax. In 1945, the U. S. Supreme Court held

that the options were compensation for services.[11] After this tax ruling, stock options provided very little advantage to executive optionees. Options were taxable when exercised, i. e., before any cash income was realized on the option.

While the provisions of the 1950 Revenue Act were still under study by Congress, the Senate Finance Committee made the following statement:

> Employee stock options are frequently used as incentive devices by corporations who wish to attract new management, to convert their officers into partners by giving them a stake in the business, to retain the services of executives who might otherwise leave, or give their employees a generally more direct interest in the success of the corporation.[12]

Congress overruled the court when it passed the Revenue Act of 1950 as an amendment to the 1939 Internal Revenue Code.

The Kennedy administration and some members of Congress opposed the special tax treatment of stock options allowed under the Revenue Act of 1950. In retort, business firms felt pressed to prove that stock options were more than a tax favor to executives--that in fact they were useful and necessary management devices. In defending the use of stock options as incentive for executives, Henry Ford II cited the experience of the Ford Motor Company in acquiring the services of a few skilled executives from outside the company on the promise that they could

> . . . acquire a stake in the company as soon as it was feasible to do so. . . We could not have offered them enough more in salary and possible bonuses to justify the risk of leaving secure positions for the uncertainties of our situation.[13]

---

[11]Commissioner v. Smith, 324 U. S. 177 (1945).

[12]Senate Miscellaneous Reports, 81st Cong., 2nd Sess., 1950, p. 59.

[13]Henry Ford II, op. cit., p. 46.

Mr. Ford summarized his position: "I am convinced that the restricted stock option is a powerful incentive to good management and an important contributor to economic progress . . ."[14]

Congress ultimately decided that ". . . it is good for the economy for management of various businesses to have a stake in their successful operation . . . this provides important incentive to expand and improve the profit positions of the companies involved."[15] Accordingly, the Revenue Act of 1964 continued the capital gains treatment of stock options.

The controversy over stock options was not restricted to private business. In the fall of 1959, the Middle South Utilities, Inc., challenged the informal rule of the Securities & Exchange Commission that public utilities were not allowed to issue stock options. Prior to that time the Securities & Exchange Commission had not been forced to take a formal position on stock options. The Commission's informal position was based on the fact that the 1935 Holding Company Act did not specifically provide for stock options, and, therefore, the Securities & Exchange Commission would not permit their use.

Several issues were discussed during the course of arguments between the Securities & Exchange Commission staff and Middle South Utilities. Middle South maintained that it was forced by competition to initiate a stock option plan to obtain capable young executives, and to retain their

---

[14] Loc. cit., p. 45.

[15] Senate Miscellaneous Reports on Public Bills, 88th Congress, op. cit., p. 89.

services. The SEC report indicated that Middle South had no record of difficulties in getting executives without stock options. Furthermore, executives who supposedly left Middle South to take jobs with stock options also got large salary increases.

Middle South declared that stock options provided key employees with greater compensation at lower cost to the company. The staff of the Securities Exchange Commission said that this claim depended upon the salary bracket of the executive. The Securities Exchange Commission computed the cost to the company as the discount from market at which the stock is sold.

Middle South argued that stock options increased employees' incentive. The SEC report contended that executives should be doing the best they can whether they have stock options or not.

Finally, February 7, 1961, the Commission reversed its position and

> . . . found that options are often a "material factor" in attracting and keeping "topflight" executives. Costs of the options were held to be "a justifiable contribution by the investors" to executives.[16]

This is especially true of newly formed companies or old companies with difficulties. In either of these situations the company may suffer a cash shortage and not be able to pay large salaries to executives.

A stock's price is influenced by a variety of factors outside management control. But strong profits, company growth and good earnings

---

[16]"A Federal O. K. for Stock Options," U. S. News and World Report, February 20, 1961, 50:92.

per share are factors known to influence market price of the stock, and these factors are influenced by management decisions. Business firms realize that one of the chief incentives at every level from clerk to executive is compensation. In the case of stock options, total compensation of the executive depends on an increase in stock value.

In the writer's opinion the stock option is a combination of compensation and incentive rather than exclusively one element or the other. The two elements, incentive and compensation, are complementary rather than contradictory.

FINANCING THE EXERCISE OF STOCK OPTIONS

Most option plans require full payment on delivery of the stock by the company. Outside financing is needed by most executives in order to exercise a favorable option. Few individuals, even highly paid executives, have $100,000 or $200,000 idle cash to finance the exercise of stock options.

One possible source of funds is a bank loan. The Federal Reserve Board sets a margin requirement which limits the percentage of market value which can be loaned by a bank for the purpose of buying stock. The current margin requirement is 70 per cent.[17] A margin requirement of 70 per cent indicates that the optionee may borrow only 30 per cent of the market price of the stock. A loan of 30 per cent of the market price often leaves the optionee still short of the necessary funds. "For

---

[17] Federal Reserve Bulletin, June 1965, p. 834.

the bank to be in a position to lend the full sum, the market price of the stock must be no less than 233 per cent above the option price."[18] Banks sometimes get around this requirement through the use of non-purpose "character" loans or a loan based on earning ability. If this type of loan is to be repaid within a year, interest rates will probably run about five to six per cent. If the loan is not to be repaid within a year, the effective rate will be about eight to nine per cent.[19]

A popular means of personally financing the exercise of an option has been the sale of a portion of the recently acquired shares to repay a short-term bank loan. For example, an employee is offered an option to purchase 3,000 shares of his employer's stock at $100, the fair market value on the grant date. He exercises the option when the market price of the stock has increased to $150, financing the purchase by a six-month non-purpose "character" bank loan at six per cent. Under the Revenue Act of 1950, a long-term capital gain could be recognized if the stock was held for six months after acquisition. At the end of six months, the executive sells 2,400 shares of stock at $150 per share. The $300,000 loan plus $9,000 interest for six months can be repaid out of the proceeds from the sale. After paying capital gains tax of $30,000, the optionee is left with a net increase of $21,000 cash. He also has 600 shares of stock with a market value of $150 per share. This type of personal financing by executives has been frowned upon by the Board of Directors and by the stockholders of several grantor corporations. Selling a large percentage of the stock as soon as possible after the required

---

[18]"Those Tricky Stock Options," Dun's Review, April 1962, 79:42.
[19]Ibid., p. 43.

holding period is incongruous with the idea of giving the executive a proprietary interest in the firm. If options are large, and disposition of the shares by the executive becomes known to the general public, confidence in the company may weaken and cause the market price of the stock to fall. This latter prospect is detrimental to stockholders who might wish to sell their stock, and also to the grantor company should it desire to do any financing through a stock issue.

This type of financing is far less likely to happen under the Revenue Act of 1964 than it was under the 1950 law. The holding period for capital gains treatment was only six months under the old law, but the 1964 changes increased the required holding period to three years after exercise of the option. Interest charges would be too high over such a long period of time to make this type of financing attractive to optionees.

Some firms have provided plans that ease the financing problem of executive optionees. Three plans are described to illustrate the possibilities available to firms desiring to aid their executives with the problem of financing stock options.

Union Carbide offers a "divident equivalent" to its executives. The optionee receives a certain number of dividend equivalents along with an option to buy the same number of shares. The divident equivalent is the right granted to an optionee to receive an amount equal to the dividend which would be received if the optionee had already exercised the option. The executive will continue to collect the dividends on these shares until he resigns or dies. When part of the options are exercised, his divident equivalents are reduced correspondingly.[20]

20 "Those Tricky Stock Options," op. cit., p. 43.

H. J. Heinz Company adopted a variation of the dividend equivalent plan. Heinz grants to certain executives "management profit sharing units" representing a certain number of shares at book value. The executive receives dividends on these shares until he leaves the firm's employ. At the time of separation from the company, the executive receives his capital appreciation--the difference between the book value of the stock when he leaves and book value when he received the credit. This appreciation is taxed as ordinary income.[21]

General Motors Corporation offers a bonus plan to selected executives which is payable partly in cash and partly in stock. The 250 executives that receive stock options are paid only 75 per cent of their bonus, with the remainder being set up as a contingent credit figured by equating the bonus into shares based on the average market value of stock for the year. An option is granted for three shares of stock for every share of contingent credit. If the option is allowed to expire, the shares in the contingent credit are paid to the executives over the next five years. If the option is exercised, the executive loses the right to receive the shares in his contingent credit. This provision means that market value must increase significantly before exercise of the option would be advantageous.

> This combination preserves General Motor's incentive-bonus plan, which is primarily an award for work done, and supplements it with a further incentive for future performance.[22]

---

[21] _Loc_. _cit_.

[22] Robert Sheehan, "The Stir over Stock Options," _Fortune_, Oct. 1962, 66:220.

ACCOUNTING FOR THE COST OF STOCK OPTIONS

What and When to Record

The American Accounting Association had made only one recommendation concerning the accounting for stock options: ". . . information concerning transactions such as stock options . . ., the results of which have not been reflected in the accounts as of the statement date, should be disclosed."[23]

The American Institute of Certified Public Accountants stated its position in Bulletin 43: "To the extent . . . options . . . involve a measurable amount of compensation, the cost of such service should be accounted for as such."[24]

The Institute maintains that the amount of compensation involved in stock options is the difference between the option price and the market value on the date of grant, provided the option price is below the market price on date of grant.[25]

Most authorities agree that the only reasonable value of a stock option is the difference between the option price and the market value on some date. Three possible dates might be used in determining the value which should be assigned to stock options--the grant date, the exercisable date, or the exercise date.

---

[23]Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements, American Accounting Association, p. 8.

[24]Accounting Research and Terminology Bulletins, Final Edition, American Institute of Certified Public Accountants, p. 119.

[25]Accounting Research and Terminology Bulletins, op. cit., p. 123.

In November, 1948, the A.I.C.P.A. issued a statement in support of the exercisable date. But in 1953 the organization transferred its support to the date of grant primarily because of the change in the tax laws. In supporting the grant date, the A.I.C.P.A. said:

> . . . the date on which an option is granted to a specific individual would be the appropriate point at which to evaluate the cost to the employer, since it was the value at that date which the employer may be presumed to have had in mind . . . the only important contingency involved is the continuance of the grantee in the employment of the corporation.
>
> The date of grant also represents the date on which the corporation foregoes the principal alternative use of the shares which it places subject to option, i.e., the sale of such shares at the then prevailing market price.
>
> The committee therefore concludes that in most cases, including situations where the right to exercise is conditional upon continued employment, valuation should be made of the option as of the date of grant.[26]

Arthur Andersen and Company argued that the date the option becomes exercisable provides a better measure of compensation.

> We have considered that the best available measure of the value of an option is the excess of the fair market value over the option price at the time the right to exercise it becomes unconditionally vested in the option holder, i.e., at the exercisable date. It is on this date that the obligation of the company to sell stock under the option at a specified price becomes definitely established for the first time. The obligation is then irrevocable, and at this point the company has given up something, usually of a measurable value . . .[27]

The date of exercise has been supported on the basis that it is not until the option is exercised that the employee has a real benefit or the firm has a real cost. Until that time the cost to the firm is only contingent. Normally, the executive will not exercise the option unless the market price rises above the option price; therefore, any

---

[26] Loc. cit.

[27] Arthur Andersen & Co., Accounting and Reporting Problems of the Accounting Profession, p. 80.

cost entered in the accounting records of the firm would misstate profits, if the option were not exercised.

Most writers on the subject of stock options feel that the date of exercise is too late to recognize the stock option in the accounts. These writers maintain that after the exercisable date the optionee has a legal right to exercise the option whenever he desires within the limits of the option. The company has no legal control over the exercise. Since the optionee has something of value after the exercisable date, it is the optionee who takes the risk involved in possible changes in the market price of the stock.

In this writer's opinion, the grant date seems the most logical date for measuring cost of a stock option to the issuing firm. The company foregoes the right to sell the stock on the open market after the grant date. The grant of the option concluded the terms of the contract between the employee and the grantor corporation. That the executive is not entitled to realize the benefits until future years, does not affect the date the contractual obligation is incurred. It is the value on the date the contractual obligation is incurred that determines the cost to the issuing company. However, the choice of a date is not necessary for the presentation of the proposal presented in the report concerning the recording of stock options in the accounts.

Where and How to Record

Edwin Campbell maintains that the Board of Directors of the issuing corporation could arrive at a realistic valuation of stock options by

using the same procedure they now use in setting a price for new stock issues. The Board could consider such factors as: industry position, economic outlook, historical rate of growth, relationship of past earnings to market valuation, dividend policy, projected growth in earnings, and the price-earnings ratio. After studying these considerations, the Board of Directors could consult with investment bankers and arrive at an estimated cost of the option. After the amount has been set by action of the Board of Directors, a deferred charge for the unamortized value of the stock options should be entered on the books with a deferred credit of the same amount. These deferred accounts would be reduced by equal amounts each year between the grant and exercisable dates. The deferred charge would be reduced by a charge against current income, and the deferred credit would be reduced by increasing a capital surplus account. Campbell maintains that this means of handling stock options provides for the proper recording of the charge for compensation and also, the increase in the value of the business due to the efforts of the executive concerned being properly reflected in the surplus account.[28] This approach is almost identical to the one presented by Paton in his _Corporation Accounts and Statements._[29]

Daniel Sweeney advocates the "cash value of services" approach in his book _Accounting for Stock Options_. This approach is also very similar to that of Mr. Campbell. Sweeney says the "cash value of services" should be arrived at by bargaining between the Board of Directors and the executive.

---

[28]Edwin D. Campbell, "Stock Options Should be Valued," _Harvard Business Review_, July-August, 1961, 39:52-58.

[29]Wm. A. Paton and Wm. A. Paton, Jr., _Corporation Accounts and Statements_, p. 48.

> The estimate of future potential for future gain in the option may be used in determining the amount of cash salary which the optionee is willing to forego for the option grant of a given number of shares, or it may be used to determine the number of shares to be granted in view of a decision to accept a certain portion of the total value of services on this non-cash basis.[30]

No recognition is given to changes in the market price of the stock since . . ."It is assumed that the optionee would be performing just as effectively if the market price were going down as if it were going up."[31]

Sweeney suggests memo entries, similar to the deferred charge and deferred credit entries of Campbell, to reflect in the finance statement the total value of services expected to be received over the option period, if the option period were to extend beyond one year.

> At the close of an accounting period, when services have been performed, the current amount of the option service cost in the memo subscription transaction . . . should be reversed, and the regular entries for the year's service cost would show the value of the executive's services thus received.[32]

Comparison of Sweeney's and Campbell's methods indicate that though the two differ slightly in technique, the final result and the theory underlying them are essentially the same.

The "option value" method is suggested by some writers as the best means for arriving at an objective value for stock options. This method is based on the assumption that the value of an option can be determined from the price at which options are being purchased and sold.

---

[30] Daniel L. Sweeney, Accounting for Stock Options, p. 191.

[31] *Ibid.*, p. 200.

[32] *Ibid.*, p. 201.

" . . . it is argued that prices on traded options can be used to derive the value of options for other periods of time and for other corporations."[33] This method has never achieved wide support within the field of accounting because executive stock options cannot be transferred except to an estate or heir on death of the optionee. Since the executive stock option is not marketable, there is no basis of comparison with options offered on the open market.

The Arthur Andersen "Accrual of value" approach presumes that the services for which the option is granted are all rendered before the option becomes unconditionally exercisable. Accordingly, it matches costs with services by comparing the fair market value of the stock at the end of each year through the date of exercisability with the fair market value at the beginning of that year.

William L. Raby, a lecturer at the University of Arizona, presents the "tax deductions foregone" method. Mr. Raby points out that two things are given with a stock option--the option itself and a tax benefit. "The cost of the latter, the tax benefit given, is of a different nature than the former. It is the foregone deduction."[34]

Mr. Raby points out that $100,000 paid to an executive in current salary is fully deductible in arriving at taxable income of the corporation. No such deduction is allowed to the corporation when stock options are used except to the extent that the executive exercised the option

---

[33]William L. Raby, "Accounting for Employee Stock Options," The Accounting Review, January 1962, 37:30.

[34]Ibid., p. 34.

early, i.e., before he has held it long enough under federal income tax laws to qualify for capital gains tax. To the extent that the executive must pay ordinary income tax, the corporation is allowed to deduct the cost from its taxable income.

Mr. Raby gives the following illustrations to compare the results on reported net income when each of the three above approaches (Sweeney's, Andersen's and Raby's) are used.

Assumptions:

1. An executive will forego $100,000 of salary for a restricted stock option.
2. The option will run for five years, but will be exercisable after two years.
3. The option is for 100,000 shares of stock at $5 per share, which is the market value on the grant date.
4. The market values at the end of each of the five years are:

1	$6.00
2	7.00
3	8.00
4	9.00
5	10.00

5. The executive exercises the option at the end of the fifth year and holds the stock so that it will qualify for a capital gains tax.[35]

Under the above assumptions, Sweeney would make the following entry for each of the five years of the option:

Salary Expense	$20,000	
Accrued Income Tax Payable		$ 9,600
Paid-In Surplus		10,400

(To record as compensation the proportionate amount of total cash compensation foregone ($100,000) in order to receive the stock option, and to record the additional tax arising from non-deductibility of service cost under stock option.)

[35] Ibid., pp. 35-36.

Because the option becomes exercisable after two years, if the Arthur Andersen approach is used, the entry to be made at the end of each of the first two years is . . .

Salary Expense	$100,000	
Paid-In Surplus		$100,000

(To record as compensation the increase in the excess of fair market value of the stock over the beginning-of-year fair market value.)

The Raby approach would require an entry at the end of each of the five years to record the tax deduction foregone.

Salary Expense	$ 48,000	
Paid-In Surplus		$ 48,000

(To record tax deduction foregone on the excess of fair market value of the stock over the beginning of year fair market value, because of use of stock options instead of cash compensation.)

Raby contends that the compensation aspect, devoid of tax aspects, can be handled under the Sweeney, Andersen or some other method. He does not argue the handling of the compensation aspect, but states that regardless of the method used, the entry to record the tax deduction foregone is necessary.

The various approaches give widely different charges to net income over the period of the option. The Sweeney approach would reduce net income by $100,000; Andersen's by $200,000; Raby's by $240,000; and "generally accepted" procedure would show no reduction in net income.

The real difference between the Raby and Sweeney approach is that the latter charges net income for the additional income tax resulting from non-deductibility of service cost under the stock option plan, whereas

Raby maintains that the amount of the expense should be the amount of the tax on the deduction foregone.

All of the above methods have one thing in common. At least part of the charge against net income is being credited to a capital surplus account. The justification for this type of entry would seem to be that the variation between the fair market value on the date chosen over the option price represents the value of the services contributed by the executive receiving the option. What is effected by this type of entry is a capitalization of retained earnings. All of the approaches have emphasized that the stock option was issued in lieu of additional current compensation. If the executive and the firm had agreed to higher cash compensation instead of the stock option the result would have been a charge against net income for the cash paid. This charge would be offset by the reduction in tax which would be owed to the government by the corporation. The value of the services could be expected to be reflected in an increased sales figure or a lower cost figure. There would be no capitalization of retained earnings. Since the nature of the stock option is considered to be that of additional compensation, one might question why there should be the capitalization of retained earnings when the stock option is used but not when the method of payment is through current cash compensation.

Expense incurred by a corporation is reflected by a reduction of assets or an increase in liabilities--not through an increase in paid-in capital. When the company grants a stock option, it is giving up something of value--the right to sell the stock at the present or on some

future date before expiration of the option. This right of the firm has a value, but it has no cost. The firm has not committed any of its resources to acquire this right.

The cost involved in a stock option is an alternative or opportunity cost. It is the cost of agreeing to sell the stock for the option price instead of retaining the right to sell it in the market at some future date when the price has risen. To record this alternative cost would be similar to recording cost in the following situation. The Board of Directors voted to sell a valuable piece of corporate property for $50,000. Two weeks after a contract to sell had been signed, a person uninformed of the sale offers the firm $75,000 for the property. To be consistent with recording a cost of the stock option, the corporation should record a $25,000 alternative cost. To make such an entry to record the opportunity cost involved in selling the property at one time instead of another would obviously be improper in current accounting practices. The same statement can be made about the suggested entries for recording a cost of stock options.

The same argument can be applied to Mr. Raby's proposal for recording the amount of the foregone tax deduction. Again, to make such an entry is to attempt to record an opportunity cost. The firm has a choice of using current compensation which is tax deductible or a stock option plan, which gives tax benefits to the employee rather than to the corporation. The decision of the Board of Directors is based on one or more factors not measurable in a counting, i.e., the possible cost to the company of losing its chief executive to a competitor. Accounting measures the cost

to the firm of completed business transactions, not the imputed opportunity cost to the firm incurred by the choice of one alternative plan over another.

It could be asked if the stockholders are not being mislead by failure of the company to record a cost connected with stock options since there is a dilution of stockholder equity.

Paton maintains that the dilution of stockholders' equity can be measured, but his presentation assumes that the option price is less than the market value on the grant date.[36] Since the option price will be 100 per cent of the market value on the date of grant in order to conform to the new tax requirements, there would be no measurable dilution. If the SEC footnoting requirements are followed, stockholders are provided with all the facts regarding the stock options. These requirements are as follows:

> (1) A brief description of the terms of each option arrangement shall be given, including (i) the title and amount of securities subject to option; (ii) the year or years during which the options were granted; and (iii) the year or years during which the optionees became, or will become, entitled to exercise the options.
>
> (2) State (a) the number of shares under option at the balance sheet date, and the option price and the fair value thereof, per share and in total, at the dates the options were granted; (b) the number of shares with respect to which options became exercisable during the period, and the option price and the fair value thereof, per share and in total, at the dates the options became exercisable; and (c) the number of shares with respect to which options were exercised during the period, and the option price and the fair value thereof, per share and in total, at the dates the options were exercised. The required information may be summarized as appropriate with respect to each of these categories.

---

[36]William A. Paton and William A. Paton, Jr., op. cit. p. 51.

(3) State the basis of accounting for such option arrangements and the amount of charges, if any, reflected in income with respect thereto.[37]

The dilution of stockholder equity is greater under a stock option than would result from an equally sized issue of stock on the grant date because with ordinary stock issues the current stockholders have the benefit of the preemptive right which is not available when the stock option is used. If stock options cause excessive dilution of stockholders' equity, flexibility in future financing can be lost or greatly reduced. If this situation should result from excessive use of stock options then the firm has incurred a real measurable cost. At the time of such future financing, such cost will be reflected in the accounts, as lower stock prices or higher interest costs. Prior to that time, the cost is unmeasurable.

The argument that stock options are a form of compensation can be misleading, because compensation is normally thought of as a cost to the corporation which must be deducted in arriving at net income. This proposal sounds especially feasible when the stock option is considered to consist of two effects--the sale of the stock at the option price and the payment of compensation to the executive. It is simple to record the receipt of cash and the issuance of stock on the exercise date. But there is no way to record the yearly accrual of compensation except by crediting paid-in surplus. To make an entry transferring a value assigned to stock options from retained earnings to paid-in capital

---

[37]Securities and Exchange Commission, <u>Accounting Series Release</u> 76, November 3, 1953, pp. 311-12.

accomplishes nothing except to make some earnings unavailable for dividends. The equity of the stockholders is exactly the same. Making a portion of retained earnings unavailable for dividends because of the stock option is not really necessary if it is realized that the stock is actually set aside for sale on the grant date and that the option price will not be less than 100 per cent of fair market value on that date.

Many avenues of research on stock options have been left untouched by this report. Among these topics are the following: (1) How effective have stock options been in accomplishing the jobs the Board of Directors intended for them? (2) Is there some way of measuring and recording the opportunity cost inherent in stock options? (3) How far down the organization chart do companies go in the issue of stock options? (4) What effect have the tax changes of the Revenue Act of 1964 had on the number of stock option plans in use by major firms? And (5) What would be the proper method of recording stock options on the corporate records if the "equity" approach is used instead of the generally accepted "entity" concept?

CONCLUSIONS

Employee stock options present financial, tax, and accounting problems. The wide use of stock options as a part of total executive compensation is the result of favorable tax laws. Stock options are used primarily to provide the optionee with income that is taxable at the capital gains rate.

In this writer's opinion, the advantages of stock options to the grantor corporation, its stockholders, and to the executive grantees outweigh its disadvantages. Some dilution of stockholder equity is involved in stock options, but normally this impact is small. Financing the exercise of stock options has been a substantial problem. Although this problem is not yet completely solved, Union Carbide and others have enjoyed partial success in its solution through the plans previously described.

The size of options and the option price are limited for those option plans which are designed to take advantage of capital gains taxation. The stricter limitations imposed by the Revenue Act of 1964 are in accordance with the best interests of the stockholders of corporations with stock option plans. Options are part compensation and part incentive. Options should be large enough to provide incentive and adequate compensation, but small enough to minimize financing difficulties.

When a qualified stock option is granted by a company, a value is given up, the right to sell the shares on the open market at a later date. This value has no cost to the firm, except an immeasurable alternative cost. In accordance with the entity concept and other generally accepted accounting principles, no cost is incurred by the company from the use of stock options and none should be recorded on the books of account.

ACKNOWLEDGMENTS

I wish to express my sincere gratitude to my major professor, Dr. Valentine Ridgway, and to Dr. James B. Hobbs and Dr. Eugene J. Laughlin who have assisted me with this report. I also want to express my thanks to Dean C. Clyde Jones, Dr. Edgar Bagley, and the other faculty members who have aided me throughout my graduate program.

BIBLIOGRAPHY

Accounting and Reporting Problems of the Accounting Profession. Arthur Andersen & Co., 1960.

Accounting and Reporting Standards for Corporate Financial Statements and Preceding Statements and Supplements. American Accounting Association, 1957.

Accounting Research and Terminology Bulletins. Final Edition. New York, New York: American Institute of Certified Public Accountants, 1961.

Baker, John C. "Stock Options at the Crossroads." Harvard Business Review, January-February 1963, 41:22-24; 26; 28-30; 164-166.

Bomeli, Edwin C. "Stock Option Plans--Full Disclosure." *The Accounting Review*, October 1962, 37:741-745.

Byron, Earl T. "Stock Options--1964 Changes." *The Journal of Accountancy*, April 1965, 119:56-63.

Campbell, Edwin D. "Stock Options Should be Valued." *Harvard Business Review*, July-August 1961, 39:52-58.

"Companies Buying Up Own Stock." *Business Week*, August 4, 1962, 1718:76-77.

Dillavou, E. R. "Employee Stock Options." *The Accounting Review*, July 1945, 20:320-326.

"A Federal O. K. for Stock Options." *U. S. News & World Report*, February 20, 1961, 50:93.

1964 Federal Tax Course. Englewood Cliffs: Prentice Hall, 1964.

Ford, Henry II. "Stock Options are in the Public Interest." *Harvard Business Review*, July-August 1961, 39:45-51.

Griswold, Erwin N. "Are Stock Options Getting Out of Hand?" *Harvard Business Review*, November-December 1960, 38:49-55.

Hearings Before the Senate Committee on Finance, Part I, 87th Cong., 1st Sess. Washington: Government Printing Office, 1962.

"How Stock Options Really Work Out." *Business Week*, February 10, 1962. 1693:88-89.

Howe, Robert J. "Price Tags for Executives." Harvard Business Review, May-June 1956, 34:94-100.

1954 Internal Revenue Code. New York: Commerce Clearing House, 1964.

McLaren, N. Loyall. "Restricted Stock Options." The Journal of Accountancy, June 1963, 115:37-42.

"More and More Employee-Owners." U. S. News & World Report, September 25, 1961, 51:124.

"A New Threat to Stock Options." U. S. News & World Report, August 14, 1961, 51:97-99.

"Options More Popular Than Ever." Business Week, June 27, 1959, 1556:64-69.

Paton, William A., and William A. Paton, Jr. "Investment of Services--Employee Stock Options." Corporation Accounts and Statements. New York, New York: Macmillan Company, 1955.

Patton, Arch. "What is an Executive Worth?" Harvard Business Review, March-April 1961, 39:65-73.

"Personal Business." Business Week, May 18, 1963, 1759:183-184.

Raby, William L. "Accounting for Employee Stock Options." The Accounting Review, January 1962, 37:28-38.

Rosow, Jerome M. "Executive Compensation in Small Companies." Harvard Business Review, May-June 1953, 31:55-63.

Ross-Skinner, Jean. "Those Tricky Stock Options." Dun's Review, April 1962, 79:42-45.

Rothschild, V. Henry. "Financing Stock Purchases by Executives." Harvard Business Review, March-April 1957, 35:136-142.

"SEC Challenged on Stock Option." Business Week, May 28, 1960, 1604:59.

Senate Report No. 2375, 81st Cong., 2nd Sess. Washington: Government Printing Office, 1950.

Sheehan, Robert. "The Stir Over Stock Options." Fortune, October 1962, 66:131-134; 214; 219-220.

Senate Report No. 830, 88th Cong., 2nd Sess. Washington: Government Printing Office, 1964.

Smyth, Richard C. "Stock Option and Stock Purchase Plans." Financial Incentives for Management, Chapter 10, New York: McGraw-Hill Book Company, 1960.

"The Solid Fringe." Time, March 6, 1964, 83:88.

"Stock Options. Are They Gold or Just Glitter?" Time, April 25, 1960. 75:98.

"The Stock Option Comes Under Fire." U. S. News & World Report, July 11, 1960, 49:105-107.

"Stock Options--Out?" Newsweek, December 21, 1959, 54:67-68.

"Stock-Option Plans: In a Bear Market, a Boon--or a Bust?" Newsweek, July 2, 1962, 60:66-71.

"Stock Options that Failed to Pay Off--How Company Officers Lost Out," U. S. News & World Report, July 2, 1962, 53:56.

Sweeney, Daniel L. "Accounting Techniques." Accounting for Stock Options, Chapter IV. Ann Arbor: University of Michigan, 1960.

"Tightening Tax Laws on Stock Options." Business Week, March 2, 1963, 1748:74.

"What Company Executives are Doing with Their Stock." U. S. News & World Report, July 2, 1962, 53:54-56.

"Where Fortunes are Being Made Again." U. S. News & World Report, May 11, 1959, 46:84-85.

"Under Fire: Stock Options." U. S. News & World Report, May 8, 1961, 50:111-13.

EXECUTIVE STOCK OPTIONS

by

SARAH JANE SENNER

B. B. A., Washburn University, 1964

AN ABSTRACT OF A MASTER'S REPORT

submitted in partial fulfillment of the

requirements for the degree

MASTER OF SCIENCE

College of Commerce

KANSAS STATE UNIVERSITY
Manhattan, Kansas

1965

The practical value of the stock option cannot be considered separately from its tax effect. The reason for the use of the stock option is to provide incentive to the executive to whom the option is granted. Its chief feature is the tax benefit. The profit recognized on disposal of stock acquired through exercise of a stock option is taxed at capital gains rates if certain requirements are met. The requirements set out by the Revenue Code of 1954 were revised and made more stringent in the Revenue Act of 1964.

Controversy over stock options has centered on whether such options represent compensation or incentive. Those who maintain that the options represent compensation believe that the gain from sale of stock acquired under such options should be taxed at ordinary income tax rates. Others argue that stock options are granted to give key executives a proprietary interest in the firm, and thus represent an incentive rather than compensation.

Executives use various methods to finance the exercise of options. Personal financing and financing through bank loans are being replaced by company plans which ease the financing difficulty of executives.

The accounting profession reflects divided opinion concerning certain tax aspects and the compensation-incentive controversy. The American Institute of Certified Public Accountants suggests that the difference between the option price and the fair market value on the grant date should be recorded as compensation. Since the 1964 tax law provides that the option price of qualified stock options shall be 100 per cent of fair market value, no compensation is currently recorded in the

accounts. Some writers maintain that the compensatory value of stock options should be determined and recorded in the accounts.

Based upon current accounting practices and the practical consequences of adaptation of stock option plans to meet requirements of the 1964 tax law, no cost should be recorded on the books of account of the corporation.